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The UK's New "Big Bang" for Crypto Regulation

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The UK Government has successfully positioned the UK as a FinTech and Crypto-friendly jurisdiction. At the same time, in a post-Brexit world, UK regulation of the crypto sector has lagged behind developments in the EU where the MiCA Regulation is nearing the end of the European legislative process. The UK has taken a step-by-step approach following the implementation of anti-money laundering registration requirements for the crypto-asset sector. The UK Treasury Committee has been examining the potential risks and opportunities associated with the use of crypto-assets and the UK Money Laundering Regulations have been updated to introduce the travel rule for crypto-assets. In addition to this, the Law Commission has been undertaking a project on digital assets which is likely to result in legal changes to clarify the status of crypto-assets as property.

The pace of change is now picking up and the UK Government has issued a detailed consultation on new UK rules for the crypto-sector covering disclosure requirements for issuers of crypto-assets and the imposition of financial services licensing obligations on intermediaries, custodians and exchanges involved in the crypto sector. This client alert looks at the proposals set out in the UK Treasury's *Consultation on the Future Financial Services Regulatory Regime for Cryptoassets* (the "Treasury Consultation") and the announcement made in relation to the new crypto marketing rules, both issued on 1 February 2023.

The new UK rules will impact UK-based businesses as well as crypto businesses located outside the UK (e.g., US or other offshore crypto-exchanges). Businesses in the UK will need to obtain authorisation from the Financial Conduct Authority ("FCA") when the new rules come into force and enhance their systems, controls and governance arrangements to meet the new increased regulatory standards. US and other non-UK business will need to comply with the new requirements in order to access the UK market. The UK presently takes a benign approach to cross-border business in the UK. This will start to change in 2023 with the introduction of the new UK marketing rules (for financial promotions) and subsequently with the new authorisation requirements. Non-UK firms will need to navigate the new requirements and will find the UK less open to cross-border business.

Crypto Advertising and Marketing – Financial Promotion Rules

The financial services regulatory regime in the UK does not presently regulate the marketing of crypto-assets. Both the UK Treasury and the FCA have consulted on the introduction of new rules. For example, in CP 22/2 the FCA consulted on "*Strengthening our financial promotion rules for high risk investments, including cryptoassets*". Pending these new rules coming into force, issues around the suitability and accuracy of crypto-related advertising have to date been dealt with under wider advertising rules administered by the Advertising Standards Authority. This has resulted in a number of findings against crypto businesses.

Following the consultation process, the UK Government has stated that it will bring crypto marketing activities within the regulatory net under the existing financial promotions framework. This framework is set out under section 21 of the Financial Services and Markets Act 2000 ("FSMA")

which imposes restrictions on the issue of an invitation or an inducement to engage in an investment activity. This regime will be applied to promotions relating to a “qualifying cryptoasset” meaning that only an FCA authorised firm would be able to issue or approve crypto advertisements or other marketing.

These proposals have caused considerable disquiet in the crypto sector. Crypto-asset businesses registered with the FCA under the UK Money Laundering Regulations are not authorised persons under FSMA and, therefore, under the original Government proposals would not have been able to issue their own marketing communications. A registered UK crypto business would therefore have needed to involve an FCA authorised firm in approving its marketing materials, which could include its website, all communications with customers and advertising. Given that very few authorised firms would have the expertise or risk appetite to perform this role, there were industry-wide concerns that crypto businesses would effectively be precluded from engaging in any promotional activities.

The Government has taken note of the concerns raised by the sector and is now intending to implement an exemption that would allow UK-registered crypto-exchanges and custodians to issue financial promotions without being “fully” authorised by the FCA.

The UK Treasury stated in an announcement issued on 1 February that “this exemption will enable cryptoasset businesses registered with the FCA under the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (‘AML/CTF regulations’), who are not otherwise authorised persons, to communicate their own financial promotions in relation to qualifying cryptoassets (defined for the purposes of the Section 21 exemption). Registered cryptoasset businesses relying on this exemption will not be able to approve financial promotions or to communicate their own financial promotions in relation to other controlled investments”.

The Government will give the FCA powers to make rules applying to financial promotions communicated in reliance on this exemption. These are likely to mirror existing FCA financial promotion rules which are intended to ensure that communications are clear, fair and not misleading. Typically this will mean including risk warnings and product information.

The new rules will also impact non- UK crypto businesses targeting customers in the UK. The financial promotion rules under FSMA apply to any communication that is capable of having an effect in the UK. Offshore crypto businesses will need to ensure that a UK FCA authorised person approves their UK-related promotions or that an exemption under the UK’s Financial Promotion Order applies.

The financial promotion rules are being fast-tracked and will come into force within 4 months of being made in the UK Parliament.

The New Regulatory Regime

Background

In line with pre-Brexit EU standards, the UK already requires crypto-exchanges and custodians to register with the FCA for anti-money laundering compliance purposes. This registration falls short of “full” authorisation from the FCA and naturally focuses on financial crime issues requiring firms to perform customer due diligence, transaction monitoring and other measures to mitigate money laundering and terrorist financing risks. While the registration process in the UK was rigorous and the FCA took a close interest in governance and other more general issues such as the viability of firm’s business models, registration for AML purposes is less onerous than a full UK regulatory licence (i.e., “*authorisation*” under FSMA).

The UK is now consulting on the introduction of a full financial services regulatory authorisation for various participants in the crypto sector. The UK proposals, set out in HM Treasury’s Consultation on [the Future Financial Services Regulatory Regime for Cryptoassets](#) are similar in scope to the EU’s

Markets in Crypto Assets Regulation. However, the UK is proposing to integrate regulation of the crypto-sector into the existing FSMA regulatory framework. Businesses already registered with the FCA for AML compliance purposes will need to apply for full authorisation at the appropriate time.

The UK Government is intending to introduce crypto regulations in distinct phases. These are:

- Phase 1 to cover fiat-backed stablecoins;
- Phase 2 to cover activities relating to other categories of crypto-assets; and
- Phase 3 to cover certain residual activities.

The new regime will apply to crypto-asset activities provided in or to the UK. This means that offshore exchanges and other businesses targeting UK clients could become subject to a UK authorisation requirement and will also need to comply with the new financial promotion rules mentioned above.

Stablecoins – Phase 1

Phase 1 involves the introduction of a regulatory regime for stablecoins and the following activities in particular:

- Issuance and redemption of a fiat-backed stablecoins;
- Execution of payment transactions or remittances involving fiat-backed stablecoins; and
- Safeguarding, or safeguarding and administering, of fiat-backed stablecoins and/or means of access to fiat-backed stablecoins (custody).

The Phase 1 initiatives are already underway through the Financial Services and Markets Bill and in a statutory instrument that will provide more detail around the regulation of stablecoins (expected in the first half of 2023). The intention of this stablecoin-related legislation is to focus on the regulation of issuers, custodians and payment service providers for fiat-backed stablecoins, reflecting their specific risks, benefits and potential use cases. It does not capture exchange or trading activities of stablecoins (which are covered in Phase 2).

UK Crypto Framework – Phase 2

Phase 2 is more broad-ranging, covering a wide spectrum of activities relating to crypto-assets and covering all financial crypto-assets as opposed to just stablecoins. As already mentioned, the UK Government states in the Treasury Consultation that it intends to include these new regulations within the existing regulatory framework established by FSMA. The scope of the new regulatory perimeter will therefore be defined in amendments to existing regulatory laws with the FCA being empowered to introduce new tailored rules that authorised crypto businesses will need to comply with once regulated by the FCA.

The Government specifically notes that it had considered establishing a bespoke regime for the crypto-sector but decided against this to ensure a level playing field and the application of the “*same risk, same regulatory outcome*” principle.

The new UK rules will cover two broad areas.

- Firstly, securities-style requirements that impose disclosure rules where there is a listing or public offer of crypto-assets.
- Secondly, rules that apply to intermediaries in the crypto sector who participate in trading, brokerage, custody services and other services.

Crypto Issuance and Listing

For crypto-asset issuance and disclosures, the Government proposes to follow a similar approach to that for securities and apply regulation when:

- A crypto-asset is admitted to trading on a regulated crypto-asset trading venue; or
- Is subject to a public offer.

In line with the approach applied to securities, the UK Treasury states that it does not intend to directly regulate the “creation” of unbacked crypto-assets under financial services regulation.

The issuance and disclosures regime for crypto-assets will be based on the wider UK prospectus regime – the Public Offer and Admissions to Trading Regime – that applies to the issue of securities. However, the Treasury confirms that this will be tailored to the specific attributes of crypto-assets. Some exemptions to disclosure requirements will be available.

The Government will set out more detailed proposals but the following requirements will be imposed:

- A minimum standard of information regarding a crypto-asset should be available so that investors are able to make informed investment decisions;
- Appropriate liability and compensation should be available for untrue or misleading statements made in disclosure / admission documents;
- An appropriate level of due diligence should be performed over the content of disclosure / admission documents;
- An appropriate level of investor protection should be offered around marketing materials and advertisements, and trading venues should have in place rules governing marketing materials / product appropriateness; and
- There should be controls or procedures to prevent a harmful offer from being made (e.g. to detect fraud).

The Government suggests that the FCA would set principles for admission and disclosure requirements that crypto-asset trading venues would then be responsible for administering. Crypto-asset trading venues would be responsible for writing more detailed content requirements for admission and disclosure documents as well as performing due diligence on the entity admitting the crypto-asset.

The Treasury recognises that the crypto sector does not map identically to the securities sector and, in particular, for some tokens there will be no centralised issuer. In relation to this the Treasury Consultation states that where there is no issuer (e.g. Bitcoin), the trading venue would be required to take on the responsibilities of the issuer if they wish to admit the asset to trading.

New Regulated Crypto-related Activities

The Government’s approach is to focus on activities carried on in relation to crypto-assets and regulate these activities as opposed to the crypto-assets themselves. Issues of transparency relating to crypto-assets, such as their features, rights and obligations, will be addressed through the application of conduct of business rules to regulated firms, as well as the financial promotion and listing disclosure rules mentioned above.

The Treasury Consultation states that the following activities will become subject to a UK financial services authorisation requirement:

- Operating a crypto-asset trading venue which supports: (i) the exchange of crypto-assets for other crypto-assets (ii) the exchange of crypto-assets for fiat currency (iii) the exchange of crypto-assets for other assets (e.g. commodities);
- Dealing in crypto-assets as principal or agent;
- Arranging (bringing about) deals in crypto-assets;
- Making arrangements with a view to transactions in crypto-assets;
- Operating a crypto-asset lending platform; and
- Safeguarding, or safeguarding and administering, a crypto-asset.

These new crypto-related regulated activities are similar in scope to existing FSMA regulated activities performed in relation to investments and other financial products.

The Government will amend existing legislation to provide that crypto-assets constitute “*specified investments*”. The effect of this will be to trigger the application of regulatory authorisation where any of the above newly regulated activities are carried on in relation to crypto-assets.

The Treasury Consultation adopts the definition of “cryptoasset” in the Financial Services and Markets Bill (i.e., any cryptographically secured digital representation of value or contractual rights that— (a) can be transferred, stored or traded electronically, and (b) uses technology supporting the recording or storage of data (which may include distributed ledger technology), while noting that this wide definition might be narrowed depending on the circumstances of its application.

This definition is capable of including tokens such as NFTs. However, the Government is clear that the focus of the legislation is on crypto-assets utilised for financial services activities (digital art assets or NFTs not used for financial services activities would remain outside scope).

Custody

The Treasury Consultation refers to the FTX scandal on a number of occasions and ensuring the protection of clients’ crypto-assets and orderly wind-down arrangements in the event of insolvency are clearly key considerations for the Government.

While custody of crypto-assets is an activity subject to a registration requirement under the UK Money Laundering Regulations, as the Treasury Consultation notes, there are currently no rules as to how firms should perform custody of crypto-assets. This raises the risk of loss of customer assets in the event of the failure of a custodian. Custody rules relating to securities are well developed under the FCA’s Client Asset Sourcebook, which ensures segregation of client assets from the custodian’s own assets.

Custody of crypto-assets will be addressed in the Government’s Phase 1 work for stablecoins and in Phase 2 for other crypto-assets.

The Treasury Consultation notes that the Government is proposing to apply and adapt existing frameworks for traditional finance custodians to crypto-asset custody services. The Government notes that modifications will need to be made to accommodate crypto’s unique features. For example, the scope of the custody activity in relation to crypto-assets will be broader in scope than traditional custody to include merely safeguarding (but not administering) assets to include firms that solely safeguard private cryptographic keys.

New Obligations

Once the new requirements come into force, firms engaged in these activities will need to apply for FCA authorisation (or, where already authorised, apply for a variation of their permissions).

In addition to this, and most importantly, firms will need to comply with new and more onerous regulatory obligations.

The FCA will formulate new, tailored rules for regulated crypto firms which are likely to be aligned with existing FCA requirements and cover issues such as:

- Senior management appointments;
- Governance arrangements, including a compliance and risk function;
- Financial crime requirements (i.e., broader obligations beyond existing AML requirements);
- Regulatory capital requirements;
- Operational resilience;
- Conflicts management;
- Conduct of business rules towards clients;
- Obligations to monitor transactions, prevent market abuse and report suspicious transactions;
- Detailed custody rules;
- Redress in the event of loss to customers;
- Data reporting;
- Resolution and insolvency; and
- Enforcement liability for authorised firms and individuals.

The Treasury Consultation contains a chapter devoted solely to market abuse issues, which signals that this is an important topic for the Government and regulators. The Treasury Consultation suggests that the Government will apply the existing MAR (Market Abuse Regulation) Regime for securities to crypto-assets. This will create new offences of manipulation in relation to crypto-assets and also require authorised firms to monitor transactions and have other systems and controls in place to mitigate risks for market abuse and manipulation.

Next Steps

The consultation has just been launched and the important details of the new regime will be developed in due course.

Additionally, some issues are not covered and will be dealt with in Phase 3 and subsequent Phases. These include De-Fi, mining and staking, sustainability issues, post-trade activities in crypto-assets and advising on crypto-assets.



If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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